Summary

Changes to the Federal income tax structure over the last two decades have resulted in a broader tax base and lower marginal income tax rates with fewer opportunities to shelter income through exclusions, deductions, and credits. Despite large increases in the amount of property that can be transferred free of tax, Federal estate and gift taxes are of continuing concern to the farm community. Social security and self-employment taxes, however, impose a much greater burden and play a greater role in investment and management decisions due to sharp increases in their tax rates and the amount of income subject to such taxes.

In 1998, the U.S. Department of Agriculture's (USDA) National Commission on Small Farms recommended that USDA evaluate the effects of the tax code on farming and of various proposed changes to such Federal policies to aid beginning farmers. This report is the result of that evaluation.

The authors adopted the farm typology developed by USDA's Economic Research Service (ERS) to differentiate several types of small farms – farms with sales under \$250,000, as defined by the Commission. The Internal Revenue Service (IRS) provided special data tabulations using the ERS typology for the study of the effects of the Federal income and social security taxes. Estimates of estate tax burdens and effects were based on USDA farm surveys.

The most important Federal taxes for farmers are the income tax, the self-employment tax, and the estate and gift tax. The current tax system provides favorable treatment to farmers, both through general tax provisions available to all taxpayers and from provisions specifically targeted to farmers. Large farms with high farm income and very small farms with high levels of off-farm income benefit most from many of these provisions. While the Federal income tax has become more progressive through the expanded earned income tax credit and new higher marginal tax brackets, overall progressivity continues to be reduced by social security taxes.

Tax policies create financial incentives to engage in tax-favored activities. In farming, tax policies reinforce other factors such as technological change and economies of size that have contributed to an increasing number of large farms. Tax benefits generally accrue to those with higher incomes – farm or nonfarm. Although very small farms do not generate enough farm income to support a family, most small farms benefit from farm losses for tax purposes because these losses reduce taxes on nonfarm income.

At the same time, many full-time farmers do not generate enough taxable income – either farm or nonfarm – to fully utilize available tax benefits. Estate tax rules encourage farmers to hold land until death and allow most farm estates – except for the very largest – to be transferred free of tax. Across the farming sector, Federal tax policies affect farmland prices, the cost of capital relative to labor, farm size and organizational structure, farm management practices, and product supply and prices.

The most significant effects of current Federal income, estate, and social security tax policies include the following:

- Exert upward pressure on farmland prices through preferential treatment of capital gains and estate taxes that increase the demand for and reduce the supply of land on the market.
- Support pre-existing trends in the increasing share of very small and very large farms.
 - Large, profitable farms benefit from tax preferences and deductions.
 - Small, lifestyle (hobby) farms use farm losses for tax purposes to offset non-farm income.
- Help established farmers or nonfarm investors outbid beginning farmers for land.
- Contribute to greater farm output and lower commodity prices resulting from more intensive use of resources.
- Favor capital investment over labor.
- Encourage environmentally friendly land use because of targeted tax incentives for conservation and land preservation activities and reduced tax benefits for harmful practices.